

STATE OF ILLINOIS  
ILLINOIS COMMERCE COMMISSION

ILLINOIS-AMERICAN WATER COMPANY )  
 )  
 ) Docket No. 02-0690  
 Proposed general increase in water and sewer rates. )

## **INITIAL BRIEF ON BEHALF OF THE CITY OF O'FALLON**

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PROPOSED GENERAL INCREASE IN	)	
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**CITY OF O-FALLON-S INITIAL BRIEF**

**I. THE COMPETITIVE ALTERNATIVE RATE AGREEMENT BETWEEN THE CITY OF O-FALLON AND THE ILLINOIS-AMERICAN WATER COMPANY BENEFITS THE OTHER CUSTOMERS OF ILLINOIS-AMERICAN, IN ADDITION TO THE COMPANY AND THE CITY, AND SHOULD BE APPROVED BY THE COMMISSION.**

The City of O-Fallon and Illinois-American Water Company have entered into a letter of intent to establish a competitive alternative rate agreement, which has been admitted into the record as Exhibit IAWC FLR-1. Both Illinois-American and O-Fallon seek the approval of this Agreement by the Commission as part of this proceeding. As set out below, the competitive alternative rate agreement provides benefits not only to O-Fallon and Illinois-American, but also to the customers each serves as well, and, consequently, it should be approved.

A[T]he City of O-Fallon is the Company=s single largest customer, not only in the Southern division, but, I believe, in the State of Illinois. It is a growing residential community in our Southern division.<sup>1</sup> It is the

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<sup>1</sup>The City of O-Fallon is expected to grow from a population of 21, 910 in 2000 (approximately 23,000 in 2003 (O-Fallon Exhibit 2.0, p. 1)) to a population of 45,875 in 2025 and O-Fallon=s existing water customer, the City of Fairview Heights, is expected to grow from its 2000 population of 15,034 to a population of 25,651 in 2025. (IAWC Exhibit DR 5 (1.8).)

fastest growing area that we serve as compared to many of the other areas in the Southern division which are stagnant and in some cases even declining.@ (Ruckman Hearing Transcript, pp. 239-40.) The City of O'Fallon used on daily average a little over 3.7 million gallons per day during 2002 (O'Fallon Exhibit 2.0, p. 2.) The City of O'Fallon, however, has demonstrated, and the Company does believe that O'Fallon does in fact have a viable competitive alternative.@ (Ruckman Hearing Transcript, pp. 239; O'Fallon Exhibit 2.0, p. 5; Rich Hearing Transcript, p. 718; O'Fallon Data Request 5.)

One alternative, and the one O'Fallon has given every indication of adopting, in the absence of a competitive alternative rate agreement, is the City of St. Louis. (Ruckman Hearing Transcript, p. 239; O'Fallon Exhibit 2.0, p. 5); Rich Hearing Transcript, pp. 721, 725, 727-8.) St. Louis has the extra capacity, and has approached the City of O'Fallon with a very low rate on several occasions, including just a few weeks before the hearing in this proceeding. (Ruckman Hearing Transcript, p. 239; O'Fallon Exhibit 2.0, p. 5; IAWC Exhibit DR 2 (1.7).) St. Louis has offered to sell the City of O'Fallon water at a rate between 35 and 75 cents per thousand gallons depending on the delivery point. (O'Fallon Exhibit 2.0, p. 5.) The cost of the water delivered from St. Louis to O'Fallon could range from about \$1.40 per thousand gallons to \$1.85 per thousand gallons. (Ruckman Hearing Transcript, pp. 246-47; Rich Hearing Transcript, 717, 722.) With interest rates as low as they are, the low end of the estimated range would most likely be achieved. Also, although O'Fallon prefers the St. Louis option, the City of Collinsville has offered to supply the City of O'Fallon with water for \$1.41 per thousand gallons. (IAWC Exhibit DR 6 (1.12).) The competitive alternative rate is clearly within the range of the City's cost to go independent. (Ruckman Hearing Transcript, p. 240.) Indeed, the competitive alternative rate agreement is set on the high end of the range of cost that O'Fallon's engineering study showed. (Ruckman Hearing Transcript, p. 247.)

The St. Louis option is viable.<sup>2</sup> Even the Commission's staff has acknowledged this fact, albeit guardedly. (I.C.C. Staff Exhibit 18 (revised), pp. 15-16.)<sup>3</sup> The City of O'Fallon has done extensive planning and study of this competitive alternative. (Ruckman Hearing Transcript, p. 239; IAWC Exhibits DR 2 (1.7); DR 3 (1.8); DR 4 (1.9); DR 5 (1.10); DR 6 (1.12); Rich Hearing Transcript, pp. 715-18.) And, if the present rate application of the Company is approved, the St. Louis option would become even more attractive. As Dean Rich testified:

A 22% increase would reduce the pay back time on a loan to build a connection to St. Louis by 3 to 4 years minimum and definitely make it a viable project. In addition, we believe a rate increase of this magnitude would spur other IAWC customers to take water with or from the City of O'Fallon, making the acquisition from St. Louis cost effective in a very short period of time.

(O'Fallon Exhibit 2.0, p. 5.) A company witness testified: "I believe there is a high likelihood that the City of O'Fallon will go through with their plans to install the pipeline, absent some movement from the Company

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<sup>2</sup>The cost to the City of going independent would be entirely paid off within 20 years or less. The system will have an expected useful life of at least 50 years, with only a limited refurbishing cost for certain items. (IAWC Exhibits DR 4 (1.9) and DR 5 (1.10).) This would make a move to become independent of the Company very profitable to the City after the first 20 years.

<sup>3</sup>Given differences in the assumed cost of water supplied by St. Louis, the cost of water supplied by Illinois-American, the cost of constructing the main, the interest rate to be paid for any debt to fund the construction of the main, and the annual increase in sales, the results of the City's analysis of the costs of constructing a main from St. Louis to the City of O'Fallon would change, but the project appears to be close to beneficial for the City of O'Fallon.®

to react to their competitive alternative. \*\*\* O'Fallon has indicated to us personally and publicly that they have strongly considered the pipeline project and that unless the Company is able to match what they believe the cost would be under the pipeline project, they would in fact leave.” (Ruckman Hearing Transcript, pp. 245-46.) Without a competitive alternative rate agreement, the City of O'Fallon is at the juncture of making decisions now that will send the City on a road of no return away from the Company's system. (Rich Hearing Transcript, p. 725.)

As Dean Rich's testimony points out, the competitive alternative rate agreement would not only hold the City of O'Fallon within the Company's system, but it would also avoid what could be a competitive force taking other customers away from the Company's system (*e.g.*, Rich Hearing Transcript, p. 719.) Being a municipality, the City of O'Fallon could compete with the Company's system free of any regulation or restriction from the Commission. 220 ILCS 5/3-105; *Inland Real Estate Corp. v. Village of Palatine*, 146 Ill. App. 3d 92, 100, 496 N.E.2d 993, 1003 (1<sup>st</sup> Dist. 1986) (holding that municipally owned public utilities are excluded from Illinois Commerce Commission review by statute.) Indeed, among the risks listed by the Company (which, in fact, the Company is already experiencing with respect to other municipalities) is having parts of its system condemned for municipal use. (IAWC Exhibit 1.0, p. 18.) The competitive alternative rate agreement prevents such competitive pressures from driving up the costs that must be shouldered by other customers who have no alternative (*c.f.* Luth, I.C.C. Staff Exhibit 18 (revised), p. 9), even in the absence of any municipal condemnation. Rumer, of the I.C.C. Staff, testified:

To the extent that large volume customers have the capacity to seek other sources of water supply, if they were to leave the Company's system or to reduce demand, all of the Company's customers would be disadvantaged by bearing additional revenue requirements.

(I.C.C. Staff Exhibit R-6.0, p. 2.)

Even if the City were merely to remove itself from the Company system, without attracting away

other customers, the affect on other customers would be dramatic as compared to the negligible affect that the competitive alternative rate agreement will have. Under Mr. Luth's (I.C.C. Staff) revised cost of service study, the Company calculates that the annual differential in cost between the general rate and the competitive alternative rate agreement, if spread over the other customers of the single tariff pricing group would be only one and one-half cents per thousand gallons. This translates into nine cents per month. (Rucker Hearing Testimony, pp. 241-42.) If, however, the City of O'Fallon were to leave the system by going with a pipeline to St. Louis, the impact on the other customers of the single tariff pricing group would be a minimum of 74 cents per month, or 12 **2** (rather than one and one-half) cents per thousand gallons for the typical residential customer using 6,000 gallons per month. (Rucker Hearing Testimony, p. 242.) And that is only the minimum.

If O'Fallon did solicit other municipalities to connect to their pipeline from St. Louis, there is the potential of even greater revenue loss. (Rucker Hearing Testimony, p. 242; I.C.C. Staff Exhibit R-6.0, p. 2.) Other municipalities are open to the possibility of becoming customers of an independent O'Fallon water system if they can get water for less than from the Company. (IAWC Exhibits DR 1.7 and DR 1.12.) Actually, the Company's second largest wholesale customer was already considering attaching to the proposed O'Fallon pipeline from St. Louis. (Rucker Hearing Testimony, pp. 242-43.) Clearly, the customers of the single tariff pricing group are much better off retaining O'Fallon as a customer compared to what the consequences would be if O'Fallon was lost to the Company as a customer. (Rucker Hearing Testimony, p. 243.)

The competitive rate that would be set by the agreement is at the high-end of the possible range of cost to bring water from St. Louis. Although it could cost as little as \$1.40 per thousand gallons, it could

run as high as \$1.85 per thousand gallons.<sup>4</sup> (Rucker Hearing Testimony, p. 246.) The \$1.69 rate provided in the agreement is not only well above the low end, but also the midpoint of the range ( $(\$0.45) \div 2 = \$0.225 + \$1.40 = \$1.62$  is the midpoint).

Also, the competitive alternative rate is not fixed at \$1.69 for the forty-year life of the agreement. As long as there is an increase in the designated cost of living index, the rate under the agreement will increase year after year. (IAWC Exhibit FLR-1.) In fact, it is possible that over time, depending on how Company rates compare to inflation, that O'Fallon's rates could increase to levels approximating general service territories. (Ruckman Hearing Testimony, p. 241.)

As previously established, the rate reduction is justified by the benefit to other customers in keeping the City of O'Fallon on the Company's system and picking up a share of the costs that would otherwise fall on the shoulders of the Company's other customers, and justified by protecting the Company from a newly spawned competitor that could take further income from the Company's system, thus protecting the Company's other customers from having to assume an ever increasing share of the costs.

It should be noted that this is not the first rate agreement between the Company and the City of O'Fallon. Previously, there was a water requirements rate agreement that also had a forty year term, that ended in 1982. (Ruckman Hearing Transcript, p. 240.) This forty year agreement merely reinstitutes such a contractual basis for the relationship. This agreement is unexceptionable, reasonable, and should be approved.

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<sup>4</sup>This, of course, assumes water would be brought from St. Louis rather than O'Fallon leaving the Company system for an even cheaper source closer to home, such as the City of Collinsville.



## **II. ARGUMENTS IN THE ALTERNATIVE SHOULD THE COMMISSION REJECT THE COMPETITIVE RATE AGREEMENT PROPOSED BY O-FALLON AND ILLINOIS-AMERICAN**

Solely as an alternative to preserve its other issues which would become moot upon approval of the competitive alternative rate agreement (IAWC Exhibit FL-1) in the unlikely event the Commission fails to approve the competitive alternative rate agreement proposed by O-Fallon and Illinois-American, the City of O-Fallon sets out the following arguments:

### **A. Rate of Return**

O-Fallon stands on the analysis and professional opinion of its expert, Charles King that the overall rate of return should be 7.14% including a cost of equity of 9.1%. Mr. King's 9.1% cost of equity was derived directly from the discounted cash flow analysis of comparable water companies performed by IAWC's own witness, Paul Moul. (O-Fallon Exhibit 1.0, p. 3.) The Staff's presentation on water companies would actually lead to a slightly lower, 6.96%, rate of return based on a 9.42% cost of equity. (O-Fallon Exhibit R1.0, p. 8.) A rate of return only slightly over 7% is consistent with approximating the real world forces determining the rates of return of non-regulated, free market businesses.

Staff advocates a 10.27% return on equity, which is higher than the 10.20% allowed in the 2000 rate case (I.C.C. Docket No. 00-0340). The free market economy has been hit by recession and decline since the Company's last rate application. It, therefore, defies logic and reason that the Company should be allowed a greater rate of return in this rate case than it received in 2000 when the economy was still booming.

Since February, 2000 (I.C.C. Docket No. 00-0340 was decided on February 15, 2000), interest rates have declined. In February, 2003, the yield on 10-year Treasury bonds was only 3.90%, 262 basis

points lower than the 6.52% yield on the same bonds when the Commission last set the Company's equity return on February 15, 2000. Yields on high-grade corporate bonds have also slipped, from 6.98% in February, 2000, to 5.95% in February of 2003. Baa corporate bonds were yielding 8.29% in February, 2000, but only 7.06% in February of 2003. Accordingly, there is no justification whatever for assuming that IAWC's equity cost is higher now than it was two years ago.@ (O'Fallon Exhibit 1.0, pp. 3-4.)

### **B. Sinking Fund Approach to Removal Costs**

With inflation and a declining value of the dollar being the consistent experience of life, the sinking fund approach to removal costs proposed by O'Fallon's expert witness King is the only uninflated, intergenerationally fair, and reasonable spreading of these costs over the service life of the company's facilities.

### **C. Compensation for Risk**

The other parties' experts regarding rate of return on equity have each added a percentage component for business risk (*e.g.*, I.C.C. Staff Exhibit 16.0, pp. 2, 10, 21, 41-2, sch. 16.03; IWC Exhibit (Gorman Direct), pp. 27-30; IAWC Exhibit 7.0, pp. 9-13, 15.) The Company has listed examples of the kinds of risks to which its business is exposed. (IAWC Exhibit 1.0, pp. 17-20; IAWC Exhibit 7.0, pp. 9-11.) It is to compensate those investing in the Company for accepting the exposure to such risks that the risk premium is added into the return on equity calculation and result. If there is no risk, because unexpected expenses are ultimately collected from the rate-paying customers anyway, then there is no justification for adding in a risk premium, and for the Company receiving any Ajump up@in its return on equity as a risk premium.

The Company's witnesses testified that security has always been an overhead, which is reflected in

the Company's test year revenue requirements, as are other costs. The only reason that the Company seeks to collect security costs as deferred costs is that the large amount of security costs incurred as a result of the September 11, 2001 terrorist attacks was unexpected. (Ruckman Hearing Transcript, pp. 68, 74; Mitchem Hearing Transcript (pages not immediately available).) Indeed, just such security costs were defined by the Company's own expert, Mr. Moul, as a risk justifying the receipt of a risk premium (IAWC Exhibit 7.0, p. 10.) But, exposure to such unexpected business costs is the risk for which the company sought and received a risk premium as part of its rate case in 2000 (I.C.C. Docket No. 00-0340.)

A risk is defined as:

1. The possibility of suffering harm or loss... (The American Heritage Dictionary, 1976 (2<sup>nd</sup> College Ed.), p. 1065.)
2. Hazard, danger, peril, exposure to loss, injury, disadvantage, or destruction, and comprises all elements of danger. (Black's Law Dictionary, 1979 (5<sup>th</sup> Ed.), p. 1193.)

Therefore, the Company and its stockholders have already been compensated for this risk by seeking, receiving, and accepting the authority for a higher allowable return in the 2000 rate case, I.C.C. Docket No. 00-0340. The Company now sees a double assessment, if not recovery, for this risk, which permits the Company to have its cake and eat it too. The Commission should deny the Company's request for relief from what is an accepted and compensated assumption of risk.

#### **D. No Legal Ability to Recover Past Security Costs**

Other parties, in written testimony and by objection at hearing, have challenged the legal authority of the Commission to grant any deferred relief for the already-incurred security costs. These other parties represented to the ALJ that the legal objections to the Commission grant of any deferred relief, and response to Company cited cases, would be made in their respective briefs. The City of O'Fallon also

believes that the award of deferred costs for the increased security costs incurred is not within the authority of the Commission. However, rather than duplicating legal arguments, the City of O'Fallon adopts those contentions and arguments that will be made by other parties on this matter.

#### **E. Security Costs**

As O'Fallon's security expert James Brooks has testified, in the aftermath of the terrorist incidents of September 11, 2001 Illinois-American entered into a number of costly and dubiously effective security arrangements for which they now seek additional compensation. O'Fallon rests on the testimony in Mr. Brooks' direct and rebuttal testimony, and argue that Illinois-American's customers should not be made to shoulder the burden for the over-priced security arrangements and improvidently negotiated security contracts. Additionally, Illinois-American did not take advantage of federal and state grant opportunities to obtain contributions toward the costs of increased security expenses for its customers following September 11<sup>th</sup>. Simply stated, the Commission should not allow the costs for these "gold-plated" security arrangements and waste to be passed along to Illinois-American's customers.

#### **CONCLUSION**

The Commission should approve the competitive alternative rate agreement entered into between the Company and the City of O'Fallon. If this Agreement is approved, as it should be since it benefits not only the Company and the City but also the Company's other customers, the other issues raised and arguments made in this Brief will be rendered moot. Should this Commission not approve the competitive alternative rate agreement, then the City of O'Fallon continues to maintain the other issues and arguments in this Brief, which it believes should lead to significant reduction of any rate and rate components as approved by this Commission.



Respectfully submitted,

CITY OF O-FALLON, ILLINOIS,

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